Our Views

A vibrant corporate bond market is the long-term cure for credit mutual funds

Till about a decade back, the insurance sector was flourishing on the back of popular products like ULIP. Given the market risks associated with ULIP, the insurance regulator imposed certain restrictions regarding proportion of ULIP in the total assets under management. Despite this, the insurance sector did settle down and was soon back again on the growth path. Such surgical interventions to contain the systemic risk may be painful in the immediate term but are necessary to bring balance and stability for the future.

Like the insurance sector, the Indian mutual fund industry has also grown exponentially to ~Rs. 22 lacs crores of assets under management. To put it in perspective, this is ~17% of the total bank deposits in the country. These investments, with a significant retail investor participation, are almost equally divided between debt and equity mutual funds. Almost entire amount is in open ended funds which means that investor can ask for redemption at a short notice.

Over the years, SEBI has taken several steps to safeguard the interests of mutual fund investors. More specifically, in the last couple of years, we have seen several measures being announced to protect the interests of the investors in debt funds. Some noteworthy changes include imposition of sectoral limits, group limits, restriction from investing in unlisted securities, restriction on investment in unrated debt and provision of liquidity buffer for certain kind of funds. These measures, conceptually similar to controls in banking, provide a safety net for the investors. While this may impact the return on investments, it significantly boosts investor confidence.

However, a couple of recent cases underscore the need for continued reforms. While there could be specific causes in particular situations, there are certain fundamental issues which need to be addressed. These issues are related to performance of the investment, liquidity position and fair determination of the NAV for continuing investors.

In recent times, liquidity is one of the key challenges faced by this industry, particularly for debt funds. Equity funds, despite their large size, rarely have liquidity challenges because of the well-evolved and adequately liquid equity capital markets. Redemptions in equity funds can easily be met by liquidating the portfolio in the market. Even in the present unprecedented difficult situation, the markets are functioning well and equity funds do not face liquidity issues.

However, debt funds are handicapped by a nascent debt market that lacks depth and liquidity. For an open-ended debt fund where unit holders can demand redemption at short notice, liquidity in the market is essential. Redemption can only be met either out of new flows or by selling of underlying securities in the portfolio. An active and liquid debt market, similar to that of the equity market, could help overcome the liquidity issues of debt funds. While the Government bonds market is generally liquid in certain maturities, a vibrant corporate bond market across ratings and maturities is an absolute must for the growth of debt mutual funds.

During abnormal adverse market situations when investors make decisions based on sentiments, new inflow in funds would significantly reduce even while the requests for redemption continue to pour in. In such times, it will indeed be more difficult to liquidate the portfolio. In those exceptional circumstances a line of credit to the fund or a market making for the corporate debt portfolio will be helpful.

In conclusion, mutual fund industry is imperative for the growth of our capital markets. A well developed and liquid corporate bond market will be a significant enabler for the growth of mutual fund industry.

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